Facebook (FB)

May 18, 2012

IPO Priced to Perfection: Establishing SELL Rating; IPO Highlights GOOG Value

FORMAL RATING ON FACEBOOK ESTABLISHED AT SELL. Having previously established our valuation expectations on Facebook at $30 per share, and with the shares currently trading above $42, we formally apply a SELL rating, as shares are more than 15% above our target valuation. While we consider ourselves optimistic on the company's underlying business opportunity and regard its prospects for durable success as favorable, we view shares as being "priced for perfection".

We are wary of the disconnect between revenue growth and operating/capital expense growth expectations, adjusted for risk, given the following considerations:

- **The company is transitioning its focus towards large brand advertisers and will need to continually evolve its advertising product to satisfy their interests.** Not only does this involve longer-term uncertainty, but also shorter-term volatility in operating results.
- **Operating expenses are rising significantly** in part to satisfy the requirements of selling to large advertisers, and will contribute to depressed margins in the future.
- **Facebook will perpetually be in an "arms race" with Google and others,** and it is likely that they will need to make additional large acquisitions in the future with little to no associated revenue.
- **Capital expenditures are likely to approach $2 billion in 2012, and we don't expect these levels to abate.** If anything they will continue rising.
- **The expiration of larger-than-normal lock-up restrictions** on 1.8 billion shares (vs. approximately 400 million available for trading at the time of the IPO) means significantly more shares are likely to trade this year.

THE MARKET IS PRICING FACEBOOK AS A LESS RISKY ASSET THAN GOOGLE, WHICH WE BELIEVE IS SIMPLY NOT THE CASE. The discount rate-growth gap between GOOG and FB reflected in stock prices would be high even if Google traded at our target price of $820. However, the gap is simply unrealistic at risk-reward trade-offs made in the market today, as reflected in current prices for Google in the $600 range, more than 30% below our target price. The market may very well enable Facebook stock to rocket ahead of its fundamentals, but the logic required to support such valuations should first support much higher valuations for Google than even our target price implies. For Google investors it may at least provide a catalyst for much of Wall Street to re-assess the range to which Google has seemingly been bound since at least the beginning of 2010.

VALUATION. We value Facebook primarily on a DCF basis. Our model values with Facebook with a 19x 2017 FCF terminal on 7% long-term growth rates and 13% long-term discount rates. With our target value of $84 billion for the company, Facebook would trade at 20x 2013 EV/EBITDA, 25x FCF and 56x P/E. By contrast, Google (GOOG, BUY) currently trades at 9x 2013 EV/EBITDA, 12x FCF and 17x P/E (all figures on a GAAP basis).

RISKS. Three core risks for all web publishers relate to: 1) high degree of rivalry given an absence of barriers preventing new competition from emerging 2) overly high and increasing capital needs to remain and 3) government regulations and consumer pushback related to data management and respect for privacy.

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FACEBOOK (FB)

RATING: SELL
(Previous: N/A)

Target Price: $30.00
(Previous: $30.00)
Price (5/18/12): $42.00

MARKET DATA

52 Wk Hi - Low	N/A
Market Cap. (MM)	N/A
Avg. Daily Vol (000)	N/A

EPS	2011A	2012E	Prior
1Q	N/A	N/A	
2Q	N/A	($0.11)	
3Q	N/A	$0.08	
4Q	N/A	$0.12	
FY	N/A	N/A	
P/E	N/A	N/A	

Sales	2011A	2012E	Prior
1Q	$731	$1,058A	
2Q	$895	$1,175	
3Q	$954	$1,264	
4Q	$1,131	$1,491	
FY	$3,711	$4,988	

Sales in Millions

BALANCE SHEET DATA(12/31/11)

Cash ($)	3.9bn
Debt ($)	0.0
Debt/Equity	N/A
Book Value/Share	N/A

Source: Pivotal Research Group and Company Documents

Important Disclosures Are Located In The Appendix

IPO Priced to Perfection: Establishing SELL Rating; IPO Highlights GOOG Value

FORMAL RATING ON FACEBOOK ESTABLISHED AT SELL. Having previously established our valuation expectations on Facebook at $30 per share, and with trading starting above $42, we formally apply a SELL rating to FB because this value exceeds 15% above our target valuation. While we consider ourselves optimistic on the company's underlying business opportunity and regard its prospects for durable success very favorably, it all comes down to risk and reward relative to available alternatives. More practically, Facebook will now face increased scrutiny around some of the operating risks the company faces, and will highlight the value gap between it and Google at current prices. It will also leave open risks associated with the company when more than a billion shares – 4x the company's current float – become unrestricted as lock-ups expire over the course of 2012.

OVERHANG OF LOCK-UP EXPIRATION, CAPEX, UNPROVEN AD MODEL AND POTENTIAL CAPITAL FOR ACQUISITIONS WILL WEIGH ON STOCK. As the company is effectively "priced for perfection" and evidently ignores the risks associated with the company executing on the market's enhanced expectations, the stock's robust valuation warrants a commensurate amplification of concerns. Over the course of 2012, we think these concerns will weigh on the stock, and elaborate on those here:

- **The company is transitioning its focus towards large brand advertisers and will need to continually evolve its advertising product to satisfy their interests.** Not only does this involve longer-term uncertainty, but also shorter-term volatility in operating results. As the company's ad revenue growth has decelerated substantially in recent periods, investors will be particularly wary of the consequences of this re-orientation. While we argue this "pivot" is a solid long-term choice, it still hurts them nonetheless. GM's announcement this week that it was cutting its paid media efforts with Facebook is mostly unrelated to Facebook itself, but we believe investors will point to it as an example of a large marketer finding that Facebook doesn't work. More broadly, investors looking for reasons to dislike the stock will be very focused on the top-line metric regardless of the underlying reason, and anything other than an acceleration will be viewed unfavorably in the near term. Relatedly, investors will continue to focus on the rising usage levels of Facebook on mobile platforms, which do not presently monetize from advertising. This focus means that every success in developing a mobile platform will look like increased risk.

- Related to this transition, **operating expenses are rising significantly** in part to satisfy the requirements of selling to its large advertiser base. The transition will contribute to depressed margins in the future given the extensive service often required to satisfy large marketers' needs.

- **Facebook will perpetually be in an "arms race" with Google and others,** and it is likely that they will need to make additional large acquisitions in the future with little to no associated revenue. **Acquisitions** such as that of Instagram will inevitably occur again, and will highlight that billions more may yet be spent acquiring companies which contribute no near-term revenue.

- **High – and rising – levels of capital expenditures**, pushing north of $2 billion per year remain one of our greatest concerns for the company, although we suspect few investors will be taking the capital intensity of business into account. Facebook will spend this money to ensure the quality of its consumer experience and to continually enhance its features. They will do this in part to ensure that competitors need to spend billions of dollars (to even have a chance of "catching up"), but also to continually maintain the relevance of Facebook to the company's user base.

- **The expiration of the company's share lock-ups could hit the company hard** over the course of 2012. In particular, 91 days after the IPO (in which approximately 400 million shares will be issued), lock-up agreements covering 172 million shares will expire. Additionally, between 151 and 180 days post IPO, 247 million shares and share-equivalents will become unrestricted. Most significantly, 181 days after the IPO, lock-ups on 1.3 billion shares will expire. While we do not expect all of these shares to be sold, a significant number will be, especially if personal tax

considerations create conditions whereby individuals will prefer to sell shares in 2012 rather than 2013.

COMPARISONS AGAINST GOOGLE SHOULD FOCUS ON DIFFERENCES IN TERMINAL GROWTH AND LONG-TERM DISCOUNT RATE EXPECTATIONS. Facebook's valuation is problematic when compared against Google, as well, as Google is clearly Facebook's best comparable for risk and reward characteristics. Current market valuations of Google imply long-term discount rates of 12-13% with terminal growth prospects (beyond the year 2017) of between 4-5%. This compares with our estimated 6% terminal growth rate and 11% long-term discount rate. 64% of the company's value lies in those discounted cash flows from beyond 2017 per our model.

GOOGLE VALUATION MATRIX: STOCK PRICE (Per Share)
Varying Growth and Long-Term Discount Rate

Long-Term Growth	Long-Term Discount Rate 9%	10%	11%	12%	13%
4%	870	750	670	610	560
5%	1020	850	730	650	600
6%	1260	980	820	710	640
7%	1740	1210	950	800	700
8%	3180	1670	1170	920	780

Discount Rate / Long-Term Growth for Google Implied By Current Market Valuations

As we've described it in the past, we believe that Facebook warrants (and our model incorporates):

- A faster terminal growth rate than Google
- Higher risk than Google on a short-term basis
- Incrementally higher risk than Google on a long-term basis

From these assumptions we derived our 7% terminal growth rate and 13% long-term discount rate to yield a $30 price target.

Discount Rate / Long-Term Growth for Facebook Implied By IPO Pricing

FACEBOOK VALUATION MATRIX: STOCK PRICE (Per Share)
Varying Growth and Long-Term Discount Rate

Long-Term Growth	Long-Term Discount Rate 11%	12%	13%	14%	15%
5%	32	28	26	23	22
6%	36	31	28	25	23
7%	43	35	30	27	24
8%	53	41	34	30	26
9%	75	52	40	33	29

While it is plausible that Facebook could grow much faster than 7% on average in the years beyond 2017 (although, for point of reference, we derive a 7% growth rate by estimating growth which decelerates from 23% in 2017 towards a global GDP-like growth rate of 6% by 2027), we see few reasons why investors who are more optimistic about Facebook wouldn't *also* assume Google would continue growing at rates which are faster than our valuation implies. At the same time, it is difficult to conceive of Facebook as less risky than Google. We believe a higher discount rate must be incorporated into expectations of Facebook vs. Google.

Fitting this assessment into our valuation matrices for Facebook and Google, we can find discount rate-growth combinations which represent Facebook as riskier – at a 13% discount rate vs. 12% for Google. Not as wide a gap as we think should be present, but plausible.

However, to get to current market valuations for Google at a 12% long-term discount rate implies – at current stock prices– only 4% growth on average beyond 2017. Even arriving at our target price for Google of $820, a 7% growth rate would generally fit the bill alongside this 12% discount rate. By

contrast, to arrive at a price for Facebook of around $40 we would require a 9% terminal growth rate for Facebook alongside the aforementioned 13% discount rate. Both of these figures – and more importantly, the gaps between Facebook and Google for both growth and discount rates – are at least plausible.

DISPARITY OF VALUATIONS BETWEEN GOOGLE AND FACEBOOK WILL BE HIGHLIGHTED BY FB IPO. The discount rate-growth gap for Facebook at IPO price of $38 would be high even if Google traded at our target price of $820. However, the gap is simply unrealistic at risk-reward trade-offs made in the market at current prices for Google, more than 30% below our target price. The market may very well enable Facebook stock to rocket ahead of its fundamentals, but the logic required to support such valuations would also support much higher valuations for Google than even our target price implies. For Google investors, it may at least provide a short-term catalyst for much of Wall Street to re-assess the range to which Google has seemingly been bound since the beginning of 2010.

Current Trading Data and Terminal Value Model Drivers

Current Trading Data and Terminal Value Model Drivers In $mm Except Per Share data	FB	GOOG	YHOO
CURRENT TRADING DATA			
2012E Target Stock Price	$30.00	$820.00	$18.00
Current Stock Price	------	$623.05	$14.87
• Target Upside to Current Stock Price	**------**	**32%**	**21%**
Equity Value at Target Stock Price	$84,127	$270,232	$21,537
2012E Equity Value at Current Stock Price	------	$205,327	$17,792
2012E Debt - Cash - Investments	($12,000)	($48,057)	($17,551)
Enterprise Value at Target Stock Price	$72,127	$222,175	$3,986
Enterprise Value at Current Stock Price	------	$157,270	$241
2012E Operating Income (EBIT) Margin	9.9%	26.1%	15.9%
2012E Revenue Growth (ex-GOOG-MMI)	34.4%	21.5%	-3.9%
2012E Current P/E Mutliple	------	17.6x	14.1x
2012E Target P/E Mutliple	168.6x	23.1x	17.0x
2012E EPS Growth	53.7%	19.2%	28.9%
2012E Current EV/EBITDA Multiple	------	9.7x	0.2x
2012E Target EV/EBITDA Multiple	44.1x	13.7x	2.9x
TERMINAL VALUE DRIVERS / COMPONENTS			
Terminal Value in PV Terms (2012E)	**$54,136**	**$173,791**	**$2,049**
• Terminal Value % of Target Price Enterprise Value	75.1%	78.2%	51.4%
• Terminal Value % of Current Price Enterprise Value	------	110.5%	850.7%
Revenues			
2017E Total Revenue[(a)]	$17,623	$99,632	$5,023
Operating Margins (Ex-FB Pre-2011 RSUs, Ex-GOOG-MMI, Ex-TAC, Ex-Yahoo Non-Controlling Interests)			
2017E EBIT Margin	37.0%	28.9%	24.5%
2017E Net Income Margins	27.1%	25.0%	16.0%
2017E Free Cash Flow Calculation			
2017E Net Income	$4,780	$16,020	$760
2017E D&A	$1,700	$6,023	$700
2017E Stock-Based Compensation Expense	$935	$3,200	$200
2017E Capital Expenditures/Acquisitions	($2,200)	($10,600)	($1,000)
2017E Free Cash Flow	$5,215	$14,642	$660
Near-Term Discount Rate	8.0%	7.0%	8.6%
Long-Term Growth Rate	7.0%	6.0%	0.0%
Long-Term Discount Rate	13.0%	11.0%	15.6%
Derived Terminal EV/FCF Multiple	**19.1x**	**20.0x**	**6.4x**

Source: Pivotal Research

Facebook Income Statement

FACEBOOK INCOME STATEMENT

In $mm Except Per Share data	FY08A	FY09A	FY10A	1Q11A	2Q11A	3Q11A	4Q11A	FY11A	1Q12A	2Q12E	3Q12E	4Q12E	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E
Revenue	**272.0**	**777.0**	1,975.0	**731.0**	**895.0**	**954.0**	**1,131.0**	3,711.0	**1,058.0**	**1,175.0**	**1,264.0**	**1,490.8**	4,987.8	6,656.2	**8,762.0**	**11,675.4**	**14,274.9**	**17,623.0**
• Year-Over-Year Growth	77.8%	185.7%	154.2%	111.9%	107.2%	104.3%	54.7%	87.9%	44.7%	31.3%	32.5%	31.8%	34.4%	33.5%	31.6%	33.3%	22.3%	23.5%
Costs and expenses																		
Cost of revenue	(124.0)	(223.0)	(492.0)	(167.0)	(210.0)	(236.0)	(247.0)	(860.0)	(277.0)	(279.7)	(317.9)	(332.3)	(1,206.9)	(1,634.7)	(2,173.8)	(2,919.1)	(3,601.4)	(4,483.7)
• % of Revenues	45.6%	28.7%	24.9%	22.8%	23.5%	24.7%	21.8%	23.2%	26.2%	23.8%	25.1%	22.3%	24.2%	24.6%	24.8%	25.0%	25.2%	25.4%
• % of Revenues ex-Share-Based Comp	45.6%	28.7%	24.9%	22.8%	23.1%	24.4%	21.6%	22.9%	25.8%	23.4%	24.7%	21.8%	23.8%	24.0%	24.2%	24.5%	24.7%	25.0%
Marketing and sales	(76.0)	(115.0)	(184.0)	(68.0)	(103.0)	(124.0)	(132.0)	(427.0)	(159.0)	(175.2)	(201.7)	(219.2)	(755.0)	(1,071.7)	(1,403.6)	(1,859.6)	(2,283.7)	(2,833.5)
• % of Revenues	27.9%	14.8%	9.3%	9.3%	11.5%	13.0%	11.7%	11.5%	15.0%	14.9%	16.0%	14.7%	15.1%	16.1%	16.0%	15.9%	16.0%	16.1%
• % of Revenues ex-Share-Based Comp	26.5%	14.5%	9.2%	9.3%	10.3%	11.3%	10.3%	10.3%	12.9%	12.8%	13.8%	12.8%	13.1%	14.1%	14.3%	14.6%	14.8%	15.1%
Research and development	(47.0)	(87.0)	(143.0)	(57.0)	(99.0)	(108.0)	(124.0)	(388.0)	(153.0)	(164.9)	(176.2)	(185.3)	(679.4)	(929.2)	(1,184.3)	(1,524.3)	(1,849.1)	(2,259.6)
• % of Revenues	17.3%	11.2%	7.2%	7.8%	11.1%	11.3%	11.0%	10.5%	14.5%	14.0%	13.9%	12.4%	13.6%	14.0%	13.5%	13.1%	13.0%	12.8%
• % of Revenues ex-Share-Based Comp	14.7%	10.9%	6.8%	7.3%	7.2%	7.9%	7.3%	7.4%	8.8%	8.5%	8.4%	7.4%	8.2%	8.7%	9.0%	9.2%	9.5%	9.7%
General and administrative	(80.0)	(90.0)	(122.0)	(51.0)	(76.0)	(72.0)	(80.0)	(279.0)	(88.0)	(99.3)	(109.0)	(107.7)	(403.9)	(549.7)	(727.3)	(976.8)	(1,216.5)	(1,529.0)
• % of Revenues	29.4%	11.6%	6.2%	7.0%	8.5%	7.5%	7.1%	7.5%	8.3%	8.4%	8.6%	7.2%	8.1%	8.3%	8.3%	8.4%	8.5%	8.7%
• % of Revenues ex-Share-Based Comp	22.4%	9.1%	5.7%	6.6%	6.8%	5.7%	5.7%	6.1%	6.8%	7.0%	7.2%	5.9%	6.7%	7.0%	7.2%	7.5%	7.7%	8.0%
Other Stock-Based Comp (Pre-2011 RSU)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(965.0)	(71.5)	(71.5)	(1,108.0)	(63.0)	(23.0)	(6.0)	(4.0)	0.0
Total costs and expenses	(327.0)	(515.0)	(941.0)	(343.0)	(488.0)	(540.0)	(583.0)	(1,954.0)	(677.0)	(1,684.0)	(876.3)	(916.0)	(4,153.2)	(4,248.3)	(5,512.0)	(7,285.7)	(8,954.8)	(11,105.8)
- Total Share-Based Compensation	30.0	23.0	20.0	7.0	64.0	70.0	76.0	217.0	103.0	1,077.0	192.5	201.5	1,574.0	673.0	718.0	781.0	859.0	935.0
• % of Revenues	120.2%	66.3%	47.6%	46.9%	54.5%	56.6%	51.5%	52.7%	64.0%	143.3%	69.3%	61.4%	83.3%	63.8%	62.9%	62.4%	62.7%	63.0%
• % of Revenues ex-Share-Based Comp	109.2%	63.3%	46.6%	46.0%	47.4%	49.3%	44.8%	46.8%	54.3%	51.7%	54.1%	47.9%	51.7%	53.7%	54.7%	55.7%	56.7%	57.7%
Income from operations	(55.0)	262.0	1,034.0	388.0	407.0	414.0	548.0	1,757.0	381.0	(509.0)	387.7	574.8	834.6	2,408.0	3,250.0	4,389.6	5,320.1	6,517.2
• Operating Margin	-20.2%	33.7%	52.4%	53.1%	45.5%	43.4%	48.5%	47.3%	36.0%	-43.3%	30.7%	38.6%	16.7%	36.2%	37.1%	37.6%	37.3%	37.0%
• Operating Margin ex-Share-Based Comp	-9.2%	36.7%	53.4%	54.0%	52.6%	50.7%	55.2%	53.2%	45.7%	48.3%	45.9%	52.1%	48.3%	46.3%	45.3%	44.3%	43.3%	42.3% #
Other expense, net	(1.0)	(8.0)	(24.0)	10.0	(15.0)	(24.0)	(32.0)	(61.0)	1.0	(25.0)	(30.0)	(40.0)	(94.0)	(150.0)	(200.0)	(250.0)	(300.0)	(350.0)
Income before provision for income taxes	(56.0)	254.0	1,010.0	398.0	392.0	390.0	516.0	1,696.0	382.0	(534.0)	357.7	534.8	740.6	2,258.0	3,050.0	4,139.6	5,020.1	6,167.2
Provision for income taxes	------	(25.0)	(402.0)	(165.0)	(152.0)	(163.0)	(214.0)	(695.0)	(177.0)	240.3	(125.2)	(187.2)	(249.1)	(733.8)	(915.0)	(1,138.4)	(1,255.0)	(1,387.6)
• Effective Tax Rate	------	9.8%	39.8%	41.5%	38.8%	41.8%	41.5%	41.0%	46.3%	45.0%	35.0%	35.0%	33.6%	32.5%	30.0%	27.5%	25.0%	22.5%
Net income	(56.0)	229.0	608.0	233.0	240.0	227.0	302.0	1,001.0	205.0	(293.7)	232.5	347.6	491.5	1,524.1	2,135.0	3,001.2	3,765.1	4,779.6
• Year-Over-Year Growth	-59.4%	-508.9%	165.5%	145.3%	86.0%	73.3%	20.3%	64.6%	-12.0%	-222.4%	2.4%	15.1%	-50.9%	210.1%	40.1%	40.6%	25.5%	26.9%
Shares Used for EPS Calculation																		
Basic	------	------	------	------	------	------	------	------	------	2,161.2	2,204.2	2,224.2	2,182.7	2,274.2	2,354.2	2,434.2	2,514.2	2,594.2
Diluted	------	------	------	------	------	------	------	------	------	2,741.2	2,784.2	2,804.2	2,762.7	2,808.5	2,888.5	2,968.5	3,048.5	3,128.5
Earnings Per Share																		
Basic	------	------	------	------	------	------	------	------	------	(0.14)	0.11	0.16	0.23	0.67	0.91	1.23	1.50	1.84
Diluted	------	------	------	------	------	------	------	------	------	(0.11)	0.08	0.12	0.18	0.54	0.74	1.01	1.24	1.53

Source: Pivotal Research

Facebook Discounted Cash Flow

FACEBOOK DISCOUNTED CASH FLOW MODEL

In $mm Except Per Share data	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E
Net Income	491.5	1,524.1	2,135.0	3,001.2	3,765.1	4,779.6
D&A	800.0	1,225.0	1,400.0	1,500.0	1,600.0	1,700.0
Stock-Based Compensation Expense	1,574.0	673.0	718.0	781.0	859.0	935.0
Change in Working Capital	0.0	0.0	0.0	0.0	0.0	0.0
Capital Expenditures / Acquisitions	(2,575.0)	(1,680.0)	(1,810.0)	(1,940.0)	(2,070.0)	(2,200.0)
Excess Tax Benefit From Option Exercises	1,235.4	665.0	665.0	665.0	332.5	0.0
• Options Exercised and Sold	82.1	44.2	44.2	44.2	22.1	0.0
• Stock Price at Exercise and Sale	------	------	38.0	38.0	38.0	0.0
• Tax Rate Associated With Corporate Deduction	------	------	39.6%	39.6%	39.6%	0.0
Other Changes in Cash Balances	(387.8)	(22.1)	(8.1)	(2.1)	(1.4)	0.0
Cash Raised in IPO	6,954.0	0.0	0.0	0.0	0.0	0.0
Changes in Cash Flows	8,092.0	2,385.0	3,099.9	4,005.1	4,485.2	5,214.6
NPV of Future Cash Flows	7,492.6	2,208.4	2,657.7	3,179.4	3,296.7	3,548.9

Sum of Future Cash Flows	14,891.1
NPV of Terminal Value	54,136.4
• Terminal Value:	99,742.7
Value of Future Cashflows	69,027.5
Plus: 2012E Cash+Marketable Securities	12,000.0
Plus: Assumed Real Estate Value	4,226.4
Value of Cashflows, Cash and Investments	85,253.9
Less: 2012E Debt	0.0
2012E Common Equity Value	85,253.9
Fully Diluted Shares Outstanding 2012E	2,804.2
Equity Value 2012E (Per Share)	**30.00**
Current Equity Value (Per Share)	------
2012E Equity Value Premium Vs. Current Price	N/A

KEY ASSUMPTIONS	
Near-Term Discount Rate	*8.0%*
Terminal EV/FCF Multiple	*19.1x*
Long-Term Growth Rate	*7.0%*
Long-Term Discount Rate	*13.0%*

Source: Pivotal Research

Risks

Investors will need to consider the following among the Internet advertising industry's risks which, in the most general of terms, include a high degree of potential competitive intensity, the resulting high capital investment needs and other risks associated with privacy and government regulation:

HEIGHTENED COMPETITION. Web publishing and related businesses are highly competitive, which is only partially mitigated through ongoing investment of billions of dollars in capital expenditures annually. For example, Google's paid search business – far and away its most important – primarily competes with search services offered by Microsoft. To the extent that Facebook establishes strong commercial relationships with many of the same small and medium-sized enterprises who form Google's core advertising base, that company may become a more formidable competitor for the same budgets. Similarly, the inherently open nature of the web increases the ease with which a competitor could approach and capture a portion or all of Facebook's consumers or fee-payers. Google and other companies will persistently nip at the heels of Facebook, looking for points of entry to capture a share of Facebook's market opportunity.

CAPITAL NEEDS. The consequence of this competitive intensity is that ongoing – and potentially rising – investment levels are required. It occurs in both in a publisher's facilities (for example, bringing data centers closer to consumers) and in consumer-facing activities (such as social networking and online video, which require significant spending on servers, storage and other networking gear) in order to secure a company's core business.

PRIVACY. Privacy is a worldwide issue for all companies associated with the Internet to contend with. Facebook is generally in the limelight, as it has continually pushed boundaries with its approach to user information, most infamously with Beacon, which was an advertising product intended to exchange data related to member activity on partner websites into news-feeds. Concerns were raised in large part because the system was launched without securing consent from consumers to opt-in. This particular service was discontinued in 2009, but more recently, the company entered into a settlement with the Federal Trade Commission related to the manner in which it handled other information. Because Facebook has endeared itself to advertisers in large part on the company's targeting capabilities – which depend primarily on user information – the company will continually need to walk a proverbial tightrope which balances user preferences, the law itself and the demand of the advertiser who account for so much of the company's revenue. However, the risks that Facebook faces are ultimately the same as for all publishers on the web. These illustrations are but one example, as the issue affects all publishers of web content as well as those who would monetize it by providing infrastructure and related services.

Appendix: Important Disclosures

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I, Brian W. Wieser, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company and their securities. I further certify that I have not received and will not receive direct or indirect compensation related to specific recommendations or views contained in this research report.

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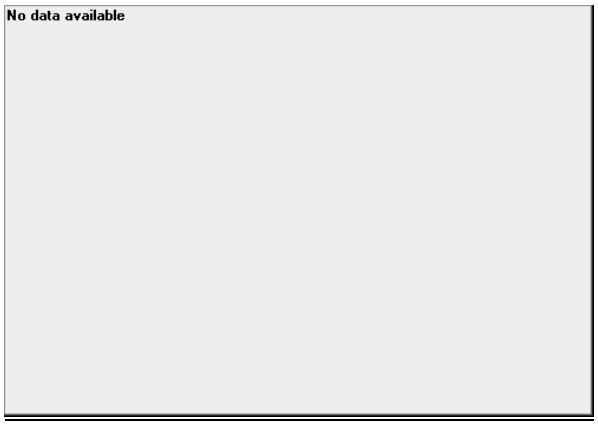
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